CIRCULAR No. 539 · OCTOBER 1939
UNITED STATES DEPARTMENT OF AGRICULTURE
WASHINGTON, D. C.

TRADING FOR OTHERS IN COMMODITY FUTURES [1]

Commodity Exchange Administration

CONTENTS

INTRODUCTION

Trading in commodity futures for others is carried on by means of controlled accounts. For the purpose of this study, a controlled account is defined as an account with a futures commission merchant, for which an individual or interest other than the owner of all or a major part of the funds employed, has the right to make purchases or sales of commodity futures. The most common instrument used to create a controlled account is a power of attorney, executed by the customer of a commission merchant and authorizing some other person to give orders for the customer.

During the past 2 years the Commodity Exchange Administration has received numerous complaints relating to controlled accounts. Misrepresentation, fraud, violations of the rules and regulations of commodity exchanges, and violations of the Commodity Exchange Act have been among the charges made. The increasing number of complaints of this nature led the Commodity Exchange Administration to make a general investigation of the use of controlled accounts in commodity trading. On August 30, 1937, a call was sent to all registered commission merchants, instructing them to file with the Administration the name and address of each customer who had authorized any other person to exercise trading control over his commodity account during the first 8 months of 1937; the name and address of each person so authorized; the date of authorization; and, if the authorization had been canceled, the date of cancelation. After a preliminary analysis of this information, a detailed investigation

[1] The information on which this report is based was obtained by numerous members of the staff of the Commodity Exchange Administration, both in Washington and in the field. The preparation of the report was largely the work of Royce A. Wight, assistant economist. The project was conducted under the general supervision of Blair Stewart, principal economist, in charge, Division of Analytical Survey.

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was made of the nature and results of the trading in a large number of accounts controlled by commodity counselors.[2]

The information in this report concerning the profitability of trading is limited, for the most part, to the year 1937. A study based on a longer period might give more conclusive evidence, but the rising prices of the first few months of 1937 followed by sharp declines later in the year permit an analysis of trading under widely varying conditions. In a few cases profit and loss figures covering other years are available. They indicate that, in general, the results were similar to those which obtained in 1937.

To present the information gathered in the investigation it has been necessary to refer to specific instances. In such cases letters have been used to designate individuals, but a different letter has been used to designate the same person in the different sections of the report.

DISTRIBUTION OF CONTROLLED ACCOUNTS

NUMBER

There were 4,488 controlled accounts in existence during all or part of the period January 1–August 30, 1937. Figures for the total number of commodity accounts in existence during this period are not available. However, it is known that there were about 25,000 commodity accounts with open commitments on January 31, 1938. Since there were doubtless many live accounts with no open commitments on this date, the total number of commodity accounts in existence was substantially above 25,000. Furthermore there were probably more commodity accounts in existence in the middle of 1937 than on January 31, 1938. Therefore, it may be inferred that controlled accounts represent less than 18 percent of the total number of commodity accounts. This does not, of course, indicate the importance of controlled accounts from the standpoint of volume traded or open commitments.

The great majority of these accounts was of recent origin. Only 3.8 percent had been in effect 5 years or more; 68.0 percent were less than 2 years old; and 40.3 percent were less than 1 year old. These figures suggest that authorizations empowering an individual to trade for the account of another are usually short-lived.

GEOGRAPHIC DISTRIBUTION

The owners of controlled accounts lived in every State, 3 Territories and 16 foreign countries. However, as indicated in figure 1, the great majority resided in the North Central and North Atlantic States where the centers of organized speculation are located. New York City and Chicago were reported as the residences of approximately one-third of the individuals who had authorized others to trade for them. There were a few instances where relatively large numbers of controlled accounts were found in small rural towns.

[2] The term "commodity counselor" is generally understood to include persons who publish forecasting and advisory services. As used in this report, however, this term refers only to persons who control commodity accounts. No study of forecasting and advisory services has been made and nothing in this report should be construed, by inference or otherwise, as an expression of approval or disapproval of such services.

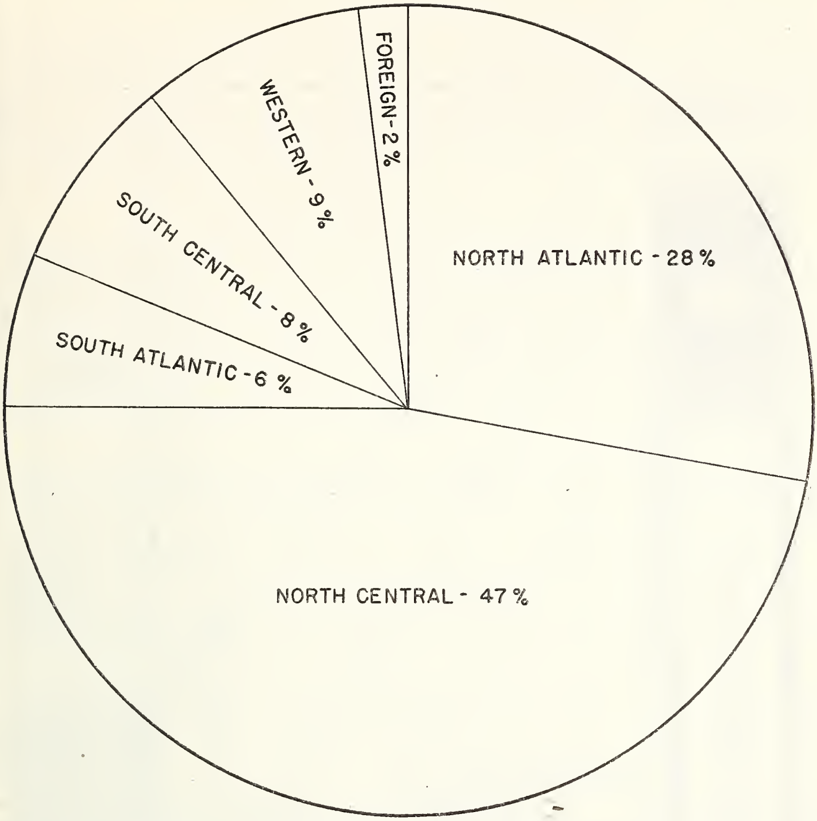

FIGURE 1.—Geographic distribution of owners of controlled accounts, January 1–August 30, 1937.

TABLE 1.—*Controlled accounts classified according to the number of accounts in each commission house, during the period January 1–August 30, 1937*

Controlled accounts in each firm (number)	Firms		Accounts		Controlled accounts in each firm (number)	Firms		Accounts	
	Number	Percentage of total	Total	Percentage of total		Number	Percentage of total	Total	Percentage of total
		Percent	*Number*	*Percent*			*Percent*	*Number*	*Percent*
0	562	69.8	0	0	26 to 50	12	1.5	481	10.7
1 to 5	123	15.3	285	6.4	51 to 100	12	1.4	822	18.3
6 to 10	41	5.1	315	7.1	Over 100	11	1.3	1,858	41.3
11 to 15	19	2.4	236	5.3					
16 to 25	25	3.2	491	10.9	Total	805	100.0	4,488	100.0

DISTRIBUTION AMONG COMMISSION MERCHANTS

Of a total of 805 reporting commission merchants, 562, or 69.8 percent, reported no controlled accounts. The number of controlled accounts in each of the remaining 243 firms varied widely, as indicated in table 1 and figure 2. In general, the number of controlled accounts

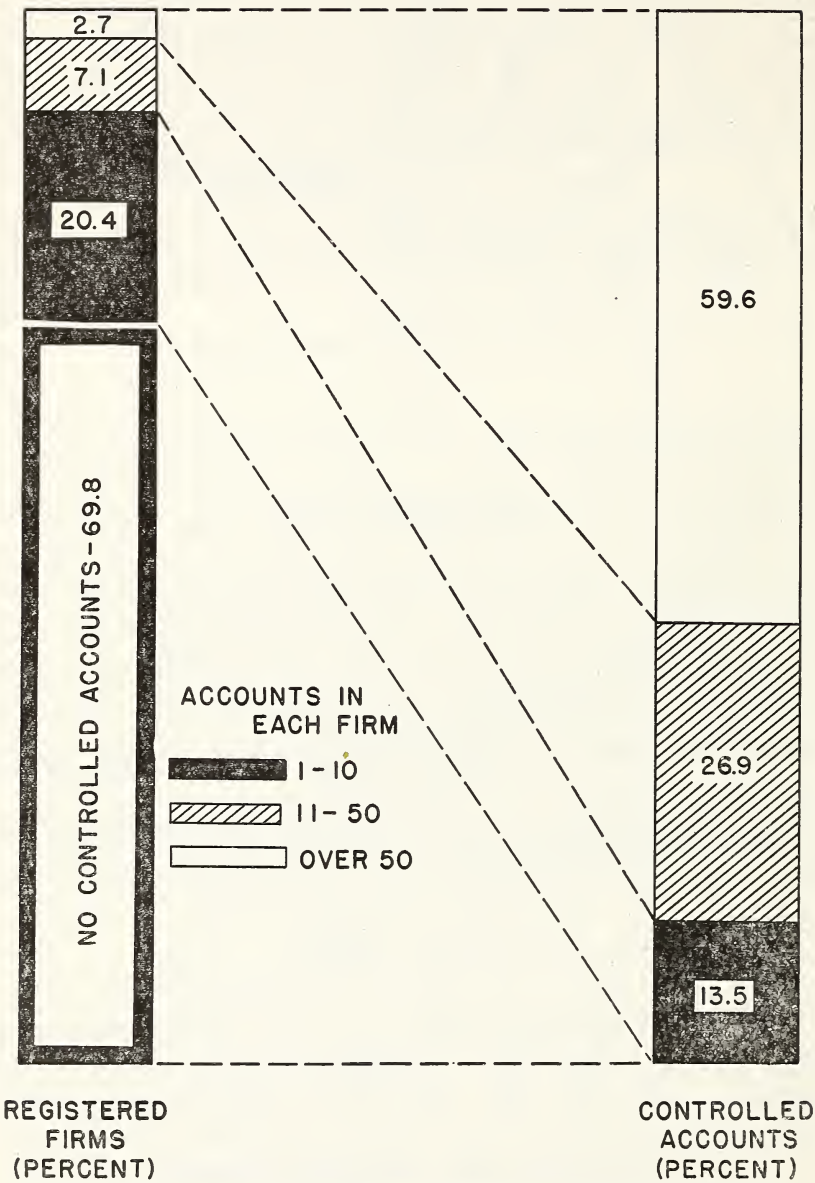

FIGURE 2.—Distribution of controlled accounts among commission merchants, by number of accounts in each firm, January 1–August 30, 1937.

in each firm was proportionate to the size of the firm, but there were several exceptions to this tendency. A few small firms reported unusually large numbers of controlled accounts. Among the 25 largest commission houses, the number of controlled accounts per firm ranged from 0 to 325. While these variations may be largely accidental, there is reason to believe that they reflect varying attitudes of commission merchants toward controlled accounts.

INDIVIDUALS AUTHORIZED TO TRADE

During the period January–August 1937, there were 3,257 individuals authorized to operate controlled accounts. As shown in table 2 and figure 3, there was a wide variation in the number of accounts controlled by each individual; 58 individuals, who held authorizations for more than 5 accounts each, controlled 674 accounts, or 14.5 percent of the total. The maximum number of accounts controlled by 1 individual during this period was 76.

TABLE 2.—*Controlled accounts classified according to the number of accounts controlled by each individual during the period January 1–August 30, 1937*

Accounts controlled by one individual (number)	Individuals		Controlled accounts		Accounts controlled by one individual (number)	Individuals		Controlled accounts	
	Number	Percentage of total	Number	Percentage of total		Number	Percentage of total	Number	Percentage of total
		Percent		*Percent*			*Percent*		*Percent*
1	2,672	82.0	2,672	57.4	6 to 9	35	1.1	250	5.4
2	360	11.1	720	15.5	10 or more	23	.7	424	9.1
3	103	3.2	309	6.6					
4	41	1.2	164	3.5	Total	3,257	100.0	[1] 4,654	100.0
5	23	.7	115	2.5					

[1] Duplication of accounts controlled by more than 1 individual explains the discrepancy in the totals of tables 1 and 2. The total number of accounts shown above exceeds the total shown in table 1 because of cases where more than 1 person had authority to trade for the same account.

There were two broad classes of individuals who controlled these accounts: (1) A nonprofessional class, which includes all individuals whose income was derived chiefly from sources other than the management of commodity accounts and who presumably received no remuneration for trading for others. This class is comprised of relatives and friends of the individuals whose accounts they manage, partners of commission houses, and corporation executives empowered to trade for the corporation. (2) A professional class which includes all persons who make a business of managing other people's accounts and receive remuneration for this service. Such persons are commonly called commodity counselors. Usually their remuneration is provided for in an agreement by which they share the profits but not the losses with the client. Thus, by trading with other people's money, they may obtain a profit but run no risk of losses at any time. In a few instances the counselor receives a fee based on the amount of money placed in the account rather than a percentage of the profits.

From such knowledge as was obtained, it did not appear that accounts controlled by the nonprofessional class were undesirable in character. This type of account permits individuals who do not have

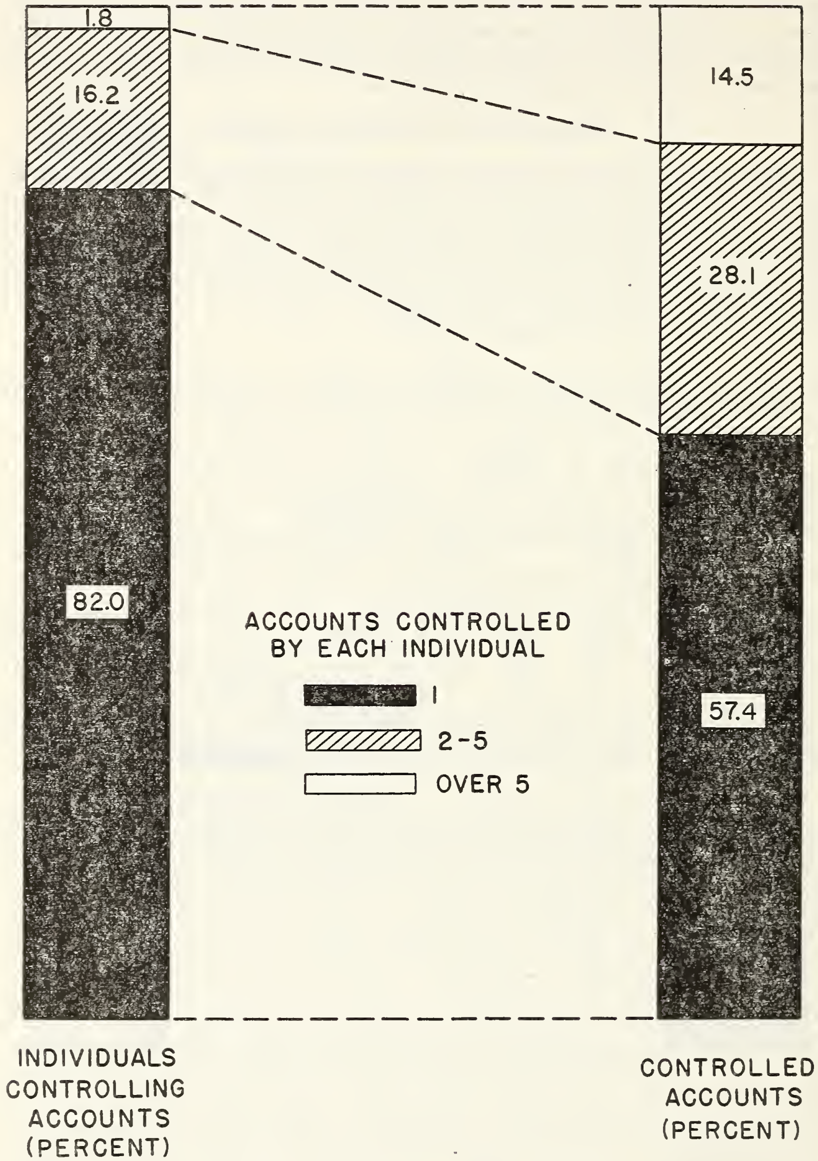

FIGURE 3.—Distribution of controlled accounts according to the number of accounts controlled by each individual, January 1–August 30, 1937.

the time to follow the market closely, or who live in towns where there is no direct communication with the market, to appoint relatives or friends as agents. There may be legitimate reasons in many such cases for granting power of attorney to someone who can direct trading operations more conveniently. The use of this device to encourage speculation by uninformed individuals, however, cannot be too strongly condemned.

Partners of commission houses sometimes agree to handle a customer's account if the customer, for one reason or another, is unable or unwilling to trade for himself. However, a partner's willingness to trade for a customer sometimes arises more from a desire to increase his commissions than to render a helpful service to his client. In a few cases it would appear that partners actively promote the use of controlled accounts, much as do commodity counselors, in order to increase their commissions. In such cases there is a very obvious incentive to active trading which may easily conflict with the clients' best interests. For example, in 1937, one partner made a trading profit of about $5,000 in the 13 accounts which he controlled, but his clients paid $15,000 in commissions and thus sustained a combined net loss of $10,000. In general, partners do not make a business of managing accounts and, therefore, for purposes of classification, they have been included in the nonprofessional group.

Employees of commission houses, to an even greater degree than partners, tend to make frequent trades and overestimate their ability to trade profitably. For these reasons several exchanges prohibit employees of member firms from handling controlled accounts. This investigation revealed, however, that some employees of commission houses were operating accounts for others.

In the case of corporations which hedge or speculate in the futures markets, the exchanges require that some officer of the corporation be empowered to give orders in the name of the corporation. The officer so empowered does not necessarily make all the decisions concerning the operation of the account which he controls.

It was not possible to determine from the data available the exact number of accounts managed by each of these classes of individuals. However, an estimated distribution is shown in figure 4. The figures for accounts controlled by Partners of Commission Houses and by Corporation Executives are accurate, but Relatives of Owners of Accounts includes only persons of the same name as the respective owners of the accounts and is, therefore, understated. Probably a large percentage of the Unclassified are actually relatives or close friends of the owners. All persons who controlled 5 or more accounts and who qualified for no other group were classified as commodity counselors. Approximately 600 accounts fell in this classification.

Of the 23 individuals who controlled 10 or more accounts each, 16 were commodity counselors, 6 were partners of commission houses, and 1 was a relative or employer of the owners of the accounts.

The number of accounts in each group bears little relation to the relative volume of trading. For example, although Relatives of Owners of Accounts constitutes a larger number of accounts than the combined total of all other classified groups, this group is probably of secondary importance from the viewpoint of volume traded.

Since the complaints which have been received by the Commodity Exchange Administration have arisen from the operations of commodity counselors, special attention has been given to their activities. The results of this special study are presented in the remainder of this report.

ACCOUNTS CONTROLLED BY COMMODITY COUNSELORS

The controlled account, as developed by commodity counselors, differs in two significant respects from accounts controlled by non-

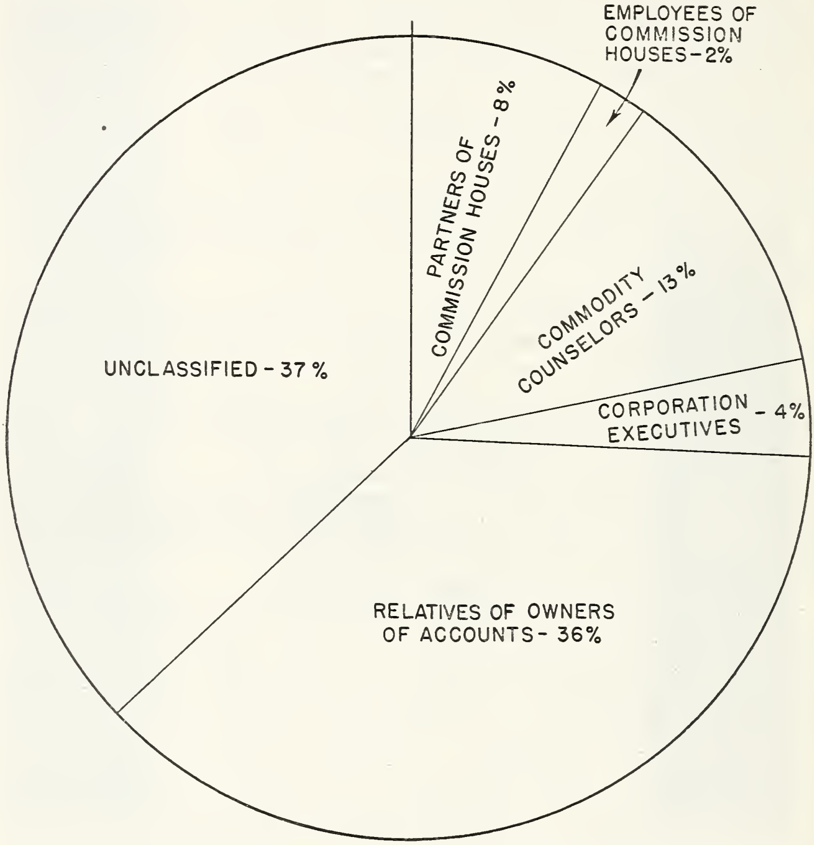

FIGURE 4.—Estimated percentage of accounts controlled by various classes of individuals, January 1–August 30, 1937.

professionals: the commodity counselor actively promotes the creation of these accounts, and he receives remuneration for his services. Commodity counselors have been instrumental in bringing into the futures markets persons of limited financial means who are unable to assume large risks and ordinarily do not speculate in commodities. On the other hand, persons who manage accounts in a nonprofessional capacity receive no direct remuneration and usually do not encourage commodity speculation by the general public.

QUALIFICATIONS OF COMMODITY COUNSELORS

In recent years many people who had been connected with the commission merchant or brokerage business before the depression have established themselves as financial counselors. These individuals claim to have an expert knowledge of market conditions which permits them to guide the trading of uninformed individuals to a profitable conclusion. On the other hand, many investors and speculators, who suffered severe losses during the depression, have since become receptive to the theory that an organization of market experts could invest more wisely and more profitably than the average individual. Unfortunately practice has not supported this theory because most of the self-styled experts have lacked the requisite ability and judgment to trade profitably. Even if a few counselors do have the necessary qualifications, it is very difficult for the prospective clients to distinguish the more skillful operators from the much larger group of those who lose their clients' money in a relatively short time.

It might reasonably be assumed that persons who represent themselves as successful speculators, capable of making profits for others, have utilized their talents to make substantial profits for themselves. It is surprising, therefore, to find that many commodity counselors are men of very limited financial resources. A personal-history investigation of all commodity counselors who controlled 10 accounts or more each, during the first 8 months of 1937, indicates that very few have been able to trade successfully for themselves. It was estimated that 11 of these 16 individuals had incomes of less than $3,000 and only 1 made more than $5,000 in 1937. Several counselors were in financial difficulties and unable to meet their obligations. One was on Government relief during part of the year. A majority of them had set themselves up as commodity counselors after they had failed in some other line of work. Their business histories indicate that, on the whole, they have been as unsuccessful as the average small speculator in forecasting price movements.[3]

METHODS OF PROMOTION

It may seem strange that many people are willing to entrust their money to counselors whose past financial accomplishments do not, on the whole, inspire confidence in their ability. However, the counselor is frequently able to give an impression of affluence, and the prospective client is usually unable to make a thorough investigation of his qualifications.

In some cases the counselor is able to obtain the recommendation of men of some standing and reputation. Several of the clients of Counselor R, for example, were referred to him by partners of the commission house through which he traded. One commission merchant gave a list of his former customers to Counselor S, who found it very helpful in securing new clients. Since a partner of a commission house is usually regarded as a man of responsibility and trust, his recommendation often carries considerable weight.

[3] No data are available on counselors who held less than 10 accounts. However, it is improbable that those who secured only a few clients were more successful than the group which obtained 10 or more each.

One of the largest commodity-counsel organizations prepared a statement showing that several of its clients had obtained large profits in a short period. As this statement was signed by an independent certified public accountant, prospective clients probably regarded it as reliable and correct. An analysis of the accounts managed by this organization revealed that the statement was false and misleading in several respects: (1) It omitted a number of unprofitable accounts. (2) The profit figures shown on the statement were incorrectly computed and, in most cases, were substantially in excess of the profits actually obtained. In fact, some accounts, for which profits were claimed, incurred net losses for the period covered. (3) Even if the profit figures had been correctly computed they would not have been indicative of this organization's trading ability as they were largely a result of transfers of unprofitable trades from the clients' accounts to a "house" account. Obviously, if several losing trades are not considered, profits can be shown without great difficulty.

Counselor C succeeded in building up a very large clientele by sending monthly "profit" checks to his customers regardless of the results of his trading operations. As a matter of fact, this counselor sustained very heavy losses in the futures markets, but the reputation he obtained by making regular "profit" payments brought him an increasing number of new clients whose money he used to pay "profits" to other customers.

Probably the most common means by which counselors obtain new clients is the advertising of selected successful transactions which they have made. Prospective clients are led to believe that a few widely publicized trades are typical of the counselor's accomplishment, whereas, in fact, they are exceptional.

METHODS OF CONTROL

Prior to the growth of the commodity-counselor business, the controlled account was often a loose and poorly defined agreement. In some cases there was only a verbal agreement between the customer, the commission merchant, and the trader who operated the account. Frequently, however, the customer wrote a letter authorizing the commission merchant to accept orders for his account from a third party. Sometimes a customer would give verbal instructions to amend a written authorization, with the result that misunderstandings frequently occurred.

The case of Mrs. X illustrates the consequences that may flow from a lax supervision of controlled accounts. In June 1937 Mrs. X gave a substantial sum of money to a Mr. Y, with the understanding that it was to be invested in grain and that an account would be opened in her name. Mr. Y, however, opened the account in his own name, and appointed a Mr. Z to give orders for the account. No written authorization was executed in favor of Mr. Z either by Mr. Y or by Mrs. X. Since Mr. Z was a customer's man in the firm of A. B. C. & Co., he was prohibited, under rule 151 of the Chicago Board of Trade, from handling a controlled account either with or without an authorization. Several months later Mrs. X was informed that market losses had absorbed 92 percent of her deposit.

In July 1937, before she had learned of the results of her first speculation, Mrs. X turned over an additional sum of money to Mr. Y. This was used to open an account in Mr. Y's name in D. E. F. & Co. Mr. Z gave all orders for this account also, although he held no written authorization. D. E. F. & Co. requested Mr. Y to give them written authorizations in favor of Mr. Z, but he did not do so until several weeks later. Meanwhile, D. E. F. & Co. permitted Mr. Z to enter orders for the account. When the account was closed it showed a loss amounting to 130 percent of the original sum.

To state this case briefly, two commission merchants permitted an individual to enter discretionary orders without authorization. They both violated the regulations of the Chicago Board of Trade in permitting a customer's man to give discretionary orders under any circumstances. The owner of the funds had no knowledge of the disposition which was being made of them.

To protect themselves and their clients against similar situations, most commission merchants now require that a client who wishes to give a third person control over his account, sign a power of attorney. A typical power of attorney reads as follows:

A. B. C. & Co.,
Commission Merchants, New York, N. Y.

GENTLEMEN: The undersigned hereby authorizes ------------------ as his agent and attorney in fact to buy, sell (including short sales), and trade in stocks, bonds, and any other securities, and/or commodities, and/or contracts relating to the same on margin or otherwise in accordance with your terms and conditions for the undersigned's account and risk and in the undersigned's name or number on your books. The undersigned hereby agrees to indemnify and hold you harmless from and to pay you promptly on demand any and all losses arising therefrom or debit balance due thereon.

In all such purchases, sales, or trades you are authorized to follow the instructions of the above-mentioned party in every respect concerning the undersigned's account with you; and he is authorized to act for the undersigned and in the undersigned's behalf in the same manner and with the same force and effect as the undersigned might or could do with respect to such purchases, sales, or trades.

The undersigned hereby ratifies and confirms any and all transactions with you heretofore or hereafter made by the aforesaid agent or for the undersigned's account.

This authorization and indemnity is in addition to (and in no way limits or restricts) any rights which you may have under any other agreement or agreements between the undersigned and your firm.

This authorization and indemnity is also a continuing one and shall remain in full force and effect until revoked by the undersigned by a written notice addressed to you by registered mail return receipt required and delivered to your main office, and shall enure to the benefit of your present firm and of any successor firm or firms irrespective of any change or changes at any time in the personnel thereof for any cause whatsoever, and of the assigns of your present firm or any successor firm.

Dated, New York, N. Y., ---------------.

Very truly yours,

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Witness.

Signature of authorized agent:

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The power of attorney signed by clients of one counselor contains the following provision, which specifically authorizes one of the abuses associated with the operation of controlled accounts:

I also understand that my agents aforesaid are acting and will act in similar capacity under trading authorizations similar to this one for numerous other

persons * * *; and that orders under this authorization may be given without designation and may be executed collectively with other orders for wheat futures and that allocations thereof may be made subsequent to the execution of said orders.

The practice of allocating orders subsequent to their execution, whether authorized or not, has been strongly condemned by the exchanges because it permits commission merchants or counselors to show partiality to some clients at the expense of others. For example, an order to buy 20 job lots (i. e., 20 lots of 1,000 bushels each) might be executed at 80 cents for 12 lots and 80¼ cents for 8 lots. The counselor could then arbitrarily decide which clients would receive the benefit of the lower price. If frequent trades are made, the exercise of this discretion may be the determining factor in the resulting profits or losses.

In recent years some counselors have resorted to indirect methods of control for the purpose of evading a regulation of the Chicago Board of Trade which prohibited persons trading under a power of attorney from receiving remuneration for their services.

Trader X, for example, controlled 23 accounts but held authorizations to trade in only 3 of them. Trading authorizations for the other 20 accounts were executed in favor of friends and employees of Counselor X. Mr. X, however, gave all the orders for these accounts and retained a large part of the profits but shared none of the losses. The persons who held the trading authorizations allegedly received no remuneration. Hence, the letter of the rules of the Chicago Board of Trade was not violated. Although the commission merchants through whom Counselor X traded were fully aware of the nature of his activities, they took no steps to prevent the operation of this scheme of evasion; on the contrary, they assisted him in promoting it.

Another plan, recently developed, eliminates altogether the necessity of signing a power of attorney. Under this method, called the joint-fund plan, the commodity counselor adds a relatively small amount, usually about 10 percent, to the money contributed by his client. The counselor then opens an account in his own name. All profits are to be divided equally or in a ratio of about 60 percent to the client and 40 percent to the counselor.[4] The counselor agrees to assume losses to the extent of his small contribution to the fund, and points to this fact as evidence of his good faith and ability. If the counselor is fortunate enough to make a profit soon after the account is opened, however, he will usually distribute these gains and thereby receive a net profit for himself even though the account may show a loss when it is finally closed. Moreover, if only those trades which show profits are closed out, over a period of several weeks or months, the account will have a realized profit of which the counselor's share may exceed his contribution to the fund. Subsequently, when it becomes necessary to close out the losing open trades, his contribution as well as the client's may be wiped out. However, since he has ob-

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[4] The promoters of this plan frankly admitted that it was originated for the purpose of evading former regulation 1820 of the Chicago Board of Trade. Nevertheless it is difficult to reconcile the provisions of the plan with par. 3 of this former regulation, which read "* * * it shall be deemed * * * inconsistent with just and equitable principles of trade * * * to accept an account where the person in whose name the account is held is acting for and on behalf of any other person and is receiving or is to receive any direct or indirect remuneration for so doing."

tained a large part of the "profits" and assumes a small part of the losses, he receives a net profit, whereas the client sustains a net loss. It was found that "profit" distributions were made in 1937 from many accounts which showed losses for the year.

This deceptive procedure of closing out profitable trades while leaving unprofitable trades open was used frequently by commodity counselors, and was not restricted to those operating on the joint-fund plan. Actual illustrations of this type of operation are given in the section on Nature of Trading (p. 14).

The joint-fund plan has certain additional characteristics which might easily give rise to fraudulent and unfair practices on the part of a counselor whose ethical standards were not of the highest. Since the account is not carried in the client's name, he does not receive confirmations of the transactions when they are made. It is entirely possible, therefore, for the counselor to transfer open trades from one account to another to suit his own interests. It is also very easy to mislead the client as to the status of his account on a given date, unless the counselor advises him of all unrealized as well as realized profits and losses. Furthermore, clients must rely on the counselor's word that he has really added a certain sum to their deposits. As a matter of actual practice, it was found that the 10-percent contribution of the counselor was merely a bookkeeping entry in most instances. The counselor added 10 percent to the credit balances of the clients' accounts on his books but did not place this money with the commission merchants. Since the client, under the joint-fund plan, has no direct relations with a commission merchant, the extent to which his interests are protected depends entirely on the ability and integrity of the counselor.

A third plan used by commodity counselors is the commodity pool. This is analogous to the joint fund but, instead of trading in a separate account for each client, the counselor pools or combines the funds of all his clients and operates them as one account. Each client shares the profits and losses in proportion to his contribution to the pool. The manager's remuneration usually consists of a percentage of the pool's profits. Since he takes his share at frequent intervals and is not penalized for losses, he may receive a substantial fee even though the pool may show a loss when it is liquidated. The compensation of the manager of one pool is based on a percentage of the liquidating value of the assets held by the pool rather than a share of the profits. While this arrangement assures the manager a fee whether he be successful or not, it is perhaps less conducive to imprudent speculation than the profit-sharing method of remuneration. The pool plan was widely used in 1933, and was a principal cause of the failure of a large commission house in the Middle West. Pool operations also figured prominently in the business of a Minneapolis counselor who was forced into bankruptcy in 1938.

Another type of organization, somewhat similar to the pool, is the investment trust. A few investment trusts trade in commodity futures, but their operations are usually limited to the securities markets. At the present time there is but one trust which deals in commodities exclusively. Many investment trusts are empowered by their charters to buy and sell commodity futures, but most of them have never exercised this power. No general analysis of their practices or accomplishment was made in connection with this investigation.

A very different type of speculative scheme used until recently by one commodity counselor was based on trading in privileges (options). The promoter of this plan solicited through the mails small sums of money with which he allegedly purchased privileges on the Winnipeg market. Although trading in privileges involves a greater risk than any other type of commodity speculation, this counselor advertised—

options that guarantee protection * * * offer the means for you to speculate in grain with small risk and with possibilities for large gains.

This counselor is now being prosecuted under section 4c (B) of the Commodity Exchange Act, which prohibits trading in privileges.

These various plans devised by commodity counselors probably stimulated the growth of their activities despite the restrictions placed on this type of trading by an important commodity exchange in 1933. The facility with which the exchange regulations were evaded evidenced the need to adopt and enforce a more effective type of regulation. The principal contract markets, in cooperation with the Commodity Exchange Administration, have already taken action on this subject.[5]

NATURE OF TRADING

By far the greatest volume of trading done by commodity counselors in 1937 was in wheat futures. Compared to wheat, the volume of trading in corn and cotton was small. Counselors made a negligible number of transactions in a few other commodities. The principal commodity exchanges through which counselors traded were the Chicago Board of Trade, the Minneapolis Chamber of Commerce, the Winnipeg Grain Exchange, and the New York Cotton Exchange.

With two exceptions, the total volume traded by any one counselor was small, and in most cases daily open commitments never equaled 200,000 bushels in all futures combined. The typical controlled account was a small job-lot account with an original equity of only a few hundred dollars. Two counselors, however, traded in relatively large volumes. Directly and indirectly through associates, Mr. T traded in approximately 15,000,000 bushels of grain in 1937 and held maximum open wheat commitments of at least 1,440,000 bushels. Counselor W, the largest trader, had transactions during 6 months of 1937 totaling 39,000,000 bushels of wheat, 11,000,000 bushels of corn, and 239,000 bales of cotton; his maximum open wheat commitments exceeded 4,000,000 bushels.

The information obtained in this investigation indicated that the trading of the typical commodity counselor was largely guided by one or more mechanical forecasting systems, based on technical market factors.

One counselor apparently followed a very simple procedure. His first trade in account No. 1, for example, was a short sale of 1,000 bushels in April 1937. A few days later he covered and then went long 1,000 bushels. Two days after that he liquidated and went short 1,000 bushels. His next trade was a purchase of 2,000 bushels, which made him long 1,000 bushels again. This procedure of changing his position from short to long and then from long to short every few days was consistently followed in most of his accounts for several months.

[5] The regulations adopted by the exchanges are discussed on p. 25.

Perhaps the most extraordinary trading system devised in recent years is the XYZ plan. This plan may best be described by quoting from the published statement of its promoter:

The account when opened takes a long and short position with exactly the same number of bushels—long in one future and short in another future. Whenever the market admits of a profit of 1 cent per bushel on either the long or short side, the profit is immediately taken and credited to the operating account. When the profit of 1 cent per bushel on either the long or short side is taken, the long or short purchase or sale is immediately replaced, keeping the account as nearly as possible in balance.

If the profit is taken on the long side, an order to replace (buy the number of bushels sold) is immediately executed at the best price obtainable, but the replacement order must be filled immediately at a higher price if necessary in order to keep the trades as nearly as possible in balance. If the profit is taken on the short side, an order to replace (sell the number of bushels bought) is immediately executed at the best price obtainable, but this replacement order must be filled immediately at a lower price if necessary in order to keep the trades as nearly as possible in balance.

WHEN CONTINUOUS SWINGS OCCUR IN EITHER DIRECTION

When wheat in the long future is purchased (for example) at 90¢ and sold at a profit at 91¢ and replaced at 91¢, a contract or job in exactly the same amount is sold in the short future at the prevailing price to keep the account as nearly as possible in balance. When the price advances to 92¢, a profit in the long future is taken on the purchase made at 91¢, immediately replacing at 92¢, selling an equal amount (contract or job) in the short future at the prevailing price to keep the account as nearly as possible in balance. This process is repeated as long as the swing in that direction continues.

In spite of some ambiguity in the above statement [6] the reader will immediately realize the absurdity of certain aspects of this plan. When a trade is closed out and immediately replaced at the same price, the only beneficiary is the person who receives the commission on the transaction. Since the trading under this plan is mainly in job lots, approximately one-half of a profit of 1 cent is absorbed by commissions. Thus the customer has a net profit of only about one-half cent per bushel and has an unrealized loss of 1 cent on the other side of the market. It would appear that whichever way the market goes the customer's realized net profit will rarely equal his losses in open trades which must eventually be closed out. While this plan is subject to various theoretical interpretations due to the ambiguous statements of its promoter, the trading has, in actual practice, been unprofitable at all times to almost all the accounts, more than 60 in number, operated under it.[7]

No attempt has been made to ascertain the relative profitability or unprofitability of various mechanical methods of trading. The evidence presented in this report suggests, however, that few, if any, of these systems possess the merits claimed for them. Moreover, there is reason to question their usefulness to the marketing functions performed by the futures markets. Mechanical trading is more closely

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[6] The ambiguity is found in the last paragraph. The situation there described is one in which a purchase has been made in one future and a sale in another. A price rise of 1 cent is assumed, and it is indicated that in such a case the future in which the long position is held would be sold and immediately repurchased. It is then stated that a sale would be made of "an equal amount (contract or job) in the short future at the prevailing price to keep the account as nearly as possible in balance." Such a sale, however, would not keep the account in balance, but would increase the short position while leaving the long position unaltered.

[7] Since the promoter of this plan did not begin operations until after August 30, 1937, he is not included among the group of 16 counselors whose accounts are shown in figs. 7 and 8.

akin to gambling than to speculation. Theoretically, speculative trading is based on individual speculators' estimates of the prices which are justified by supply and demand factors. Thus, to the extent that a speculator's judgment is sound, his trading tends to check unwarranted price declines and advances. Most mechanical systems, on the other hand, attempt to forecast price movements and go with them, whether they be warranted by fundamental conditions or not. Mechanical trading, to the extent that it is successful, is likely to produce heavy buying on price advances and heavy selling on declines, thereby accentuating rather than diminishing price fluctuations. Thus mechanical trading, based on technical market conditions, is a burden on the price-determining functions of the futures markets.

There may be a causal relationship between the use of mechanical trading systems and the frequency of the trading in most of these accounts. Trading was very active in the typical account, particularly during the first few weeks of operation. As the margins diminished, however, trades were made less frequently.

In general, the trading was similar in all the accounts controlled by any one counselor. Only a very few cases were noted where a counselor was short in some accounts and long the same future at the same time in other accounts. Spread positions between futures occurred frequently, but the evidence indicated that the spreads in these accounts were not ordinarily made to obtain a profit on the difference in the prices of two futures and, consequently, were not true spreads. A majority of them resulted from taking positions on both sides of the market on different days and in unequal amounts, whereas a true spread is a simultaneous and equal purchase of one future and sale of another in the same or different markets or of the same future in different markets. Furthermore, these spreads were usually found in accounts which contained trades showing unrealized losses. They were used to conceal from the client the fact that ill-advised trades had been made, trades which, if closed out, would have shown substantial losses. For example, a counselor who has bought just before a decline in the market may sell another future in the same market. If prices continue to decline a profit will appear on the short sale, but it will ordinarily no more than offset the increased loss on the long position. The counselor may, however, close out the short position, inform the customer that a profitable trade has been made, and receive a proportion of the "profit" as remuneration. All the while, of course, there is a greater undisclosed loss on the original purchase. Actual examples of this type of operation follow.

On September 22, 1937, Mrs. B. authorized Counselor A to direct the trading in her account in which she had placed $500. Figure 5 provides a striking illustration of the deceptive procedure followed by Mr. A in managing this account. He made both profitable and unprofitable trades almost daily, but for about 10 weeks he closed out the profitable trades only and left every losing trade open. In this manner he was able to make the account show a steadily increasing "profit" although there was a rapidly growing unrealized loss, as shown by the lower broken line on figure 5. Soon after this account was opened the unrealized losses mounted more rapidly than the realized profits. Consequently there was an increasing net loss, as indicated by the unbroken line on figure 5. On October 1 Mr. A sent Mrs.

B a check for $90.13, the amount of profits on closed trades to that date. At this time, however, the account showed losses on open trades amounting to $67.82. The receipt of this profit check undoubtedly influenced Mrs. B's decision to put an additional $500 in the account on October 11. By this date her account had an unrealized loss of $557.02 and a net loss of $257.47, but the financial ledger showed a profit of $299.55. It was not until November 29, when Mr. A was forced to close out several losing trades because of the approach of the delivery period for December wheat, that the large losses in Mrs. B's account were actually taken. On November 28 her account showed a "profit" of $875. On November 29 Mr. A sold 6,000 bushels of December wheat, which he had bought weeks previously, at a loss of $967. Thus overnight a realized profit of $875 became a realized loss of $92, as shown by the abrupt drop in the upper line of figure 5. In addition to this realized loss, the account still had an unrealized loss of $624,

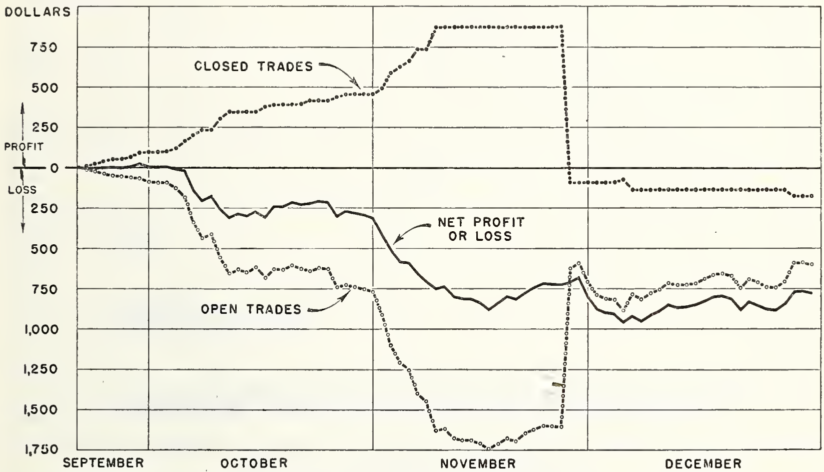

FIGURE 5.—Accumulated profits and losses on open and closed trades of account B, September 22–December 31, 1937.

making a net loss of $716 instead of a profit of $875. Thus, while Mrs. B's profit and loss statements showed continuous profits for 10 weeks, her account, under the management of Counselor A, lost 71.6 percent of the amount she had deposited during this period.

Another example of this deceptive practice is illustrated by the account of Mrs. D, also managed by Mr. A. This account was opened on August 31, 1937, and the realized profits on closed trades increased almost daily for over 2 months. As the "profits" rose Mrs. D increased her investment to a total of $1,052. By November 5 her realized profit reached $1,388, as indicated by the upper line of figure 6. During all this period, however, heavy unrealized losses were accruing in trades still held open. These losses totaled $2,542 on November 5, as shown by the lower line on figure 6. On that day Mr. A closed all these open trades and Mrs. D's $1,388 profit suddenly became a loss of $1,154, or 109.7 per cent of her investment. This is shown graphically by the upper line of figure 6, which declines sharply to coincide with the net profit or loss.

It is interesting to note that the commissions on the transactions made for Mrs. D's small account equaled $555, or 52.8 percent of her investment, during this short period.

An even more patently misleading practice is one in which a commodity counselor, who has made an unsuccessful trade, makes an opposite trade in the same future and instructs the futures commission merchant not to "make up" the trades. This means that the account is long and short the same amount in the same future, but that—on the books—the two trades have not been offset against each other. In the meantime the client is not informed that losses have been made in the trading for his account. If the market continues to move in the opposite direction from that anticipated by the counselor in his first trade, a third trade may be made and matched with the second. This

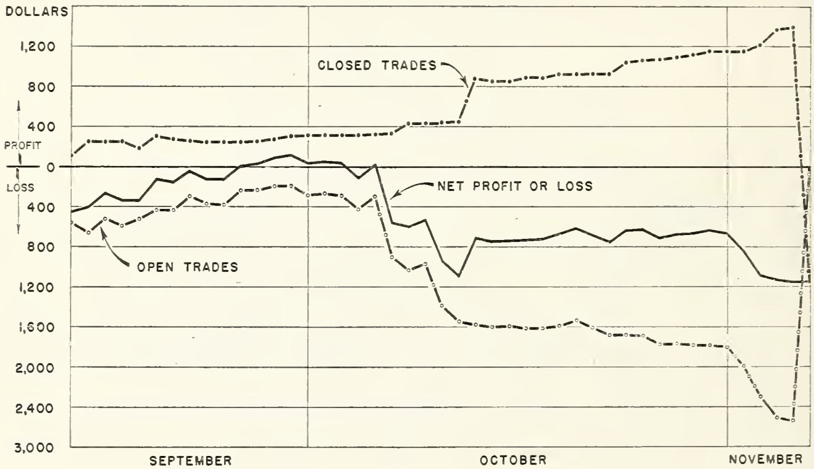

FIGURE 6. Accumulated profits and losses on open and closed trades of account D, September 15–November 6, 1937

will show a profit, although there is a large unrealized loss on the first trade. The following are examples of this type of operation:

On January 12, 1937, Counselor X, anticipating a rise in the market, purchased 1,000 bushels of May wheat for Customer A at $1.35½. Instead of rising, the price fell and a week later he sold 1,000 bushels of May wheat for the same account at $1.30⅝. This was a loss of 4⅞ cents per bushel, but the trades were not offset. The market continued to decline and, on January 22, 1,000 bushels of May wheat were bought at $1.28⅝, and this purchase was offset against the short sale. A purchase and sale statement was sent to the client, showing a profit of 2 cents per bushel on 1,000 bushels. In the meantime there was an unrealized loss of 6⅞ cents on the original purchase of January 12. Thus the client, who had actually sustained a net loss of 4⅞ cents per bushel, was led to believe that he had a profit of 2 cents per bushel.

On January 27, 1937, the commission merchant's ledger sheet for Customer B of the same counselor showed a debit of $83.64, which represented the loss on 1,000 bushels of May wheat bought at $1.35½ and sold at $1.27⅜. On January 28, however, there was a

N O T I C E

The following correction should be made in all ›ies of Circular No. 539, "Trading for Others in mmodity Futures", issued recently by the Commodity ›hange Administration, U. S. Department of Agricul- ›e:

Page 19. Legend beneath Figure 7 should read "Distribution of accounts controlled by 16 commodity counselors by size of profit or loss in 1937".

charge-back credit entry of $83.64. The counselor had evidently requested that these trades, although already made up, be reopened on the books so that the loss would not be shown.

PROFITABILITY

The information obtained in this investigation clearly indicates that the overwhelming majority of accounts managed by commodity counselors showed relatively large losses in 1937. Of the 16 counselors who controlled 10 or more accounts each during the first 8 months of 1937, 15 lost money for a majority of their clients; only 1 made profits.[8]

The financial results of the trading in 302 accounts, classified according to the amount of profit or loss, are shown in figure 7. This figure includes every account controlled by the 16 leading

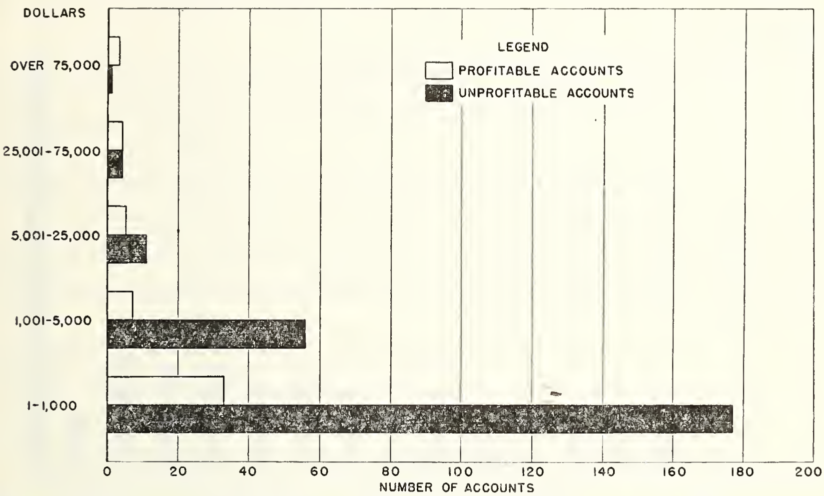

FIGURE 7. Distribution of accounts controlled by 16 community counselors by size of profit or loss in 1937.

commodity counselors during all or any part of 1937. A majority of accounts showed losses of less than $1,000. However, in most cases these amounts represented a large part of the money invested. In some instances losses exceeded 100 percent of the client's deposit.

Some of the accounts controlled by commodity counselors were profitable. In fact, as figure 7 shows, there were three accounts in which the profits in 1937 were more than $75,000. The prospective client of a counselor might therefore ask, What chance have I to make such profits? Naturally, very large profits and very large losses were made only by persons who had entrusted large amounts to the counselor. The first answer, therefore, would be that the profits, or the losses, would be related to the amount deposited. The evidence presented in figure 8 gives some basis for estimating the

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[8] In this investigation it was not feasible to secure detailed profit-and-loss data on approximately 300 accounts operated by counselors who controlled less than 10 accounts each. However, from such information as is available it appears that these accounts fared no better than the 302 accounts analyzed in the following pages.

chances of profits rather than losses.[9] Of the total of 302 accounts, 249, or 82.5 percent, showed net losses in 1937. The proportion of the total number of clients who lost is much higher than this figure, however, since approximately 4,000 clients participated in the accounts operated by Counselor P, some of which were pool accounts. Considering the total number of clients rather than the total number of accounts, over 95 percent incurred losses. In other words, the average client had less than 1 chance in 20 of profiting from trading through commodity counselors.

If the client were so unfortunate as to select—or, perhaps, be selected by—certain counselors, he would have had no chance whatever of obtaining a profit in 1937. All the accounts controlled by Counselors D, E, G, J, and L lost money. Counselors B, I, K, and M each controlled only one profitable account. The clients of only

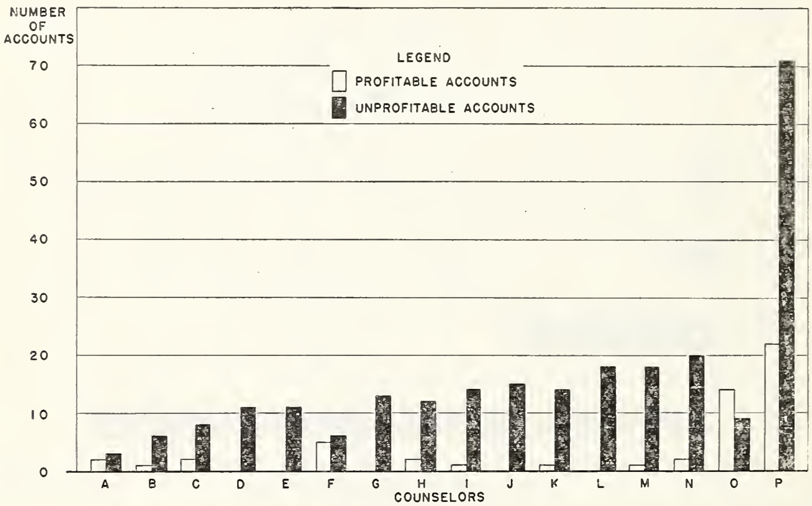

FIGURE 8. Number of profitable and unprofitable accounts controlled by each of 16 counselors in 1937.

one counselor had better than an even chance of making money. Counselor O made profits for a majority of his clients but he was the only 1 of the 16 counselors of whom this was true. Even in this case over one-third of the clients sustained losses.

An attempt was made to show the percentage profits and losses in these accounts, but the amount invested in the accounts of several counselors could not be readily determined. Percentage figures for those accounts on which accurate computations could be made are given in table 3. These figures show average percentage profits and losses in all the accounts of each of 8 counselors. The net figures range from 14.5 percent loss for the clients of Counselor A to a 98.7 percent loss for the clients of Counselor L. There was, of course, a much wider range in the profits and losses of individual clients. While table 3 includes only 8 of the 16 counselors under

[9] Less than 10 accounts each are shown for Counselors A and B because there was no trading in 1937 in some of the accounts they controlled.

consideration, it covers 191 of the 302 accounts and is fairly representative of the group as a whole.

TABLE 3.—*Percentage profits and losses in all accounts controlled by eight commodity counselors, 1937* [1]

Counselor	Profitable accounts		Unprofitable accounts		All accounts		Counselor	Profitable accounts		Unprofitable accounts		All accounts	
	Number	Profit	Number	Loss	Number	Loss		Number	Profit	Number	Loss	Number	Loss
		Pct.		*Pct.*		*Pct.*			*Pct.*		*Pct.*		*Pct.*
A	2	6.7	3	29.0	5	14.5	L	0	------	18	98.7	18	98.7
C	2	81.4	8	52.9	10	42.1	M	1	5.2	18	69.0	19	64.2
E	0	------	11	91.8	11	91.8	N	2	57.7	20	54.8	22	24.8
G	0	------	13	54.3	13	54.3	P	22	36.6	71	74.3	93	69.3

[1] With reference to fig. 7 and this table, it should be borne in mind that the clients sustained all losses but the counselors received a large share of the profits shown.

If the information obtained in this investigation is typical, and there is reason to believe that it is, the following general conclusions may be reached with respect to the profitability of trading through commodity counselors:

1. The overwhelming majority of persons who engage the services of commodity counselors sustain substantial losses.
2. A very small minority of commodity counselors is able to trade profitably. No counselor is able to make continuous profits in all his accounts over an indefinite period. Therefore this minority of successful counselors is composed of different individuals in different years.
3. Successful speculators do not ordinarily promote plans whereby they must share the profits with others.

REGULATING THE COMMODITY COUNSELOR

To put an end to the malpractices exposed by its investigation of controlled accounts and to prevent their recurrence, the Commodity Exchange Administration has proceeded along two courses: (1) the prosecution of existing abuses and (2) the recommendation of methods by which the exchanges may effectively regulate the activities of commodity counselors in the future.

PROSECUTION OF ILLEGAL ACTIVITIES

The operations of S. W. Gongoll, of Minneapolis, recently convicted of first-degree grand larceny, constitute a striking case study of many of the malpractices discussed topically in the preceding section.

Gongoll's operations as a commodity counselor first came to the attention of the Commodity Exchange Administration in the latter part of 1937. The response to the Administration's call of August 30, 1937, indicated that he controlled 16 accounts. However, when the Administration made a special investigation of the operations of commodity counselors, in March 1938, it found that Gongoll controlled, directly or indirectly, 93 accounts. Some of these accounts were operated in the name of individual clients under powers of attorney; many were joint-fund accounts; a few were pool accounts containing the

funds of many clients. Most of the accounts controlled by Gongoll showed very heavy losses. Of an estimated total capital of $500,000, used in trading in commodity futures in 1937, market losses amounted to $346,000, or 69 percent.

In May 1938 a detailed analysis was made of the daily open interest in commodity futures in all accounts controlled by Gongoll. This study indicated that he had failed to report positions in excess of 200,000 bushels of wheat, as required under the Commodity Exchange Act. The Administration therefore requested permission of Gongoll on July 7, 1938, to examine his records in order to determine whether violations of the Commodity Exchange Act existed. After considerable discussion with Gongoll's attorney, in Minneapolis and Washington, it became apparent that Gongoll would not make his records available unless forced to do so.

A complaint and notice of hearing, issued by the Secretary of Agriculture, was therefore served on S. W. Gongoll and eight affiliated organizations on August 29, 1938. The complaint alleged that Gongoll, through the means of concerns controlled by him, had violated the Commodity Exchange Act by failing to report and by reporting falsely transactions and open positions in commodities, as well as by operating as a futures commission merchant without being registered with the Commodity Exchange Administration.

The hearing, at which Gongoll and his affiliated organizations were to be given an opportunity to show cause why all contract markets should not be required to refuse them trading privileges, was scheduled for September 14, 1938. This hearing was never held, however, for the complaint of the Commodity Exchange Administration precipitated a swiftly moving series of events, revealing fraudulent operations of a very serious nature.

On September 13, 1938, S. W. Gongoll, doing business as S. W. Gongoll & Co., went into voluntary receivership. Involuntary bankruptcy proceedings against him were filed in the United States district court on September 15. On September 16 a warrant was issued for Gongoll's arrest on charges of first-degree grand larcency. Meanwhile the Administration continued its investigation, and inquiries were launched by the Securities Commission of Minnesota, the Securities and Exchange Commission, the Post Office Department, and the Bureau of Internal Revenue.

Investigators encountered immediate difficulty in penetrating the financial maze erected by Gongoll, as he had either failed to keep, or had destroyed or secreted important records. For this reason the amount of the losses and the number of clients involved can only be estimated. However, the statements of clients and employees furnished much information concerning the methods and the extent of Gongoll's operations.

The Gongoll organization consisted of S. W. Gongoll & Co. and several affiliated companies, incorporated in 8 States from Florida to Washington. The major part of the business was centered in and around Minneapolis. A staff of approximately 100 salesmen and clerks was employed by these various companies. Most of the salesmen knew little or nothing about the futures markets. Previous to their employment by Gongoll many of them had been in totally unre-

lated lines of business. The following testimony is an example of their background and knowledge:[10]

Q. Your business for the past few years had been with the Gongoll Co.?
A. Four years.
Q. What was your business prior to that?
A. I was selling salt.
Q. Will you tell me what "bids and offers" are?
A. I can't tell you what bids and offers are. The only thing I can tell is what I used in selling—that was explained by Mr. Gongoll. I never understood that well enough to explain it to a client. I said to Mr. Gongoll, "Isn't that insurance to the wheat trader?" He said that is exactly what it was. I said, "Wouldn't it be better to explain to the client in the terms that we know what it is?" He said, "I suppose it would." So I explained it as insurance; that it was based on the same principle as fire insurance.

The basic technique employed by Gongoll in enlarging his clientele was the monthly payment of "profits" of 15 to 30 percent per annum to all customers regardless of whether his trading in the futures markets was profitable or not. These payments actually were a partial return of capital, but the customers received statements reading "enclosed check for profits on wheat," etc. According to the testimony of one of Gongoll's employees, "During the entire history of the company it entered profits for its customers on their accounts." Knowledge of these payments was spread by customers to their friends and lent a degree of plausibility to the false and misleading statements made by Gongoll and his salesmen.

That Gongoll's scheme of paying unearned "profits" had the desired effect is well illustrated by the statement of one of his clients:[11]

Q. Did the percent profit that he [Gongoll] paid change any during the period that you know of?
A. In October 1937 it did.
Q. Did it go up or down?
A. Up.
Q. What had it been before October?
A. About $1.67 or $1.76 [a month].
Q. That is, about $1.60 per $100 invested?
A. Yes.
Q. Then, after October?
A. Last November he paid $2.80 on $100.
Q. Did you ever hear any reason for the increase in the amount he paid?
A. He said wheat had gone up and he made that money.[12]
Q. Was there any special effort made to have you put in more money at about this time, when the increased dividends were paid?
A. Mr. * * * [a salesman] came out then and said it was paying out well and we ought to put more in. So in December I put the other $300 in.
Q. The reason you put in $300 was largely because of the increased dividend paid in October 1937?
A. Yes.
Q. You put in another $300 in July 1938 because Mr. * * * [the salesman] said it would continue to pay the high dividend?
A. Yes.

Although Gongoll's records have not been made available for analysis, the disposition of the assets held by him can be indicated in a general manner. There were three principal channels which absorbed customers' funds: Market losses, payment of fraudulent "profits" out

[10] Statement of a Gongoll salesman given to Hennepin County (Minn.) attorney, September 17, 1938.
[11] Made before an official of the Commodity Exchange Administration at Minneapolis, October 7, 1938.
[12] The facts were that wheat prices declined sharply in October and November 1937 and Gongoll sustained very heavy losses in the market. Fearing that the severe drop in prices had affected Gongoll adversely, a number of his customers withdrew their funds. Whereupon Gongoll increased his "profit" payments to attract new money.

of capital, and payment of high commissions and salaries. Market losses, running to several hundred thousand dollars, were incurred in 1937 and 1938. The customers' investments were seriously impaired by these losses alone, but the concurrent payments of unearned "profits" greatly accelerated the dissipation of their capital. A substantial sum was also squandered in the remuneration of employees, as indicated by their statements. The manager of one Gongoll-controlled company made the following statement:[13]

A. I went on Gongoll's pay roll the first of April [1938].
Q. At what salary?
A. $100 a week plus expenses from Seattle. I was to get 25 percent of the net profits of the corporation [in addition to salary].
Q. Your compensation was paid direct by Gongoll?
A. Yes. Commissions by Financial Associates of Washington. Commissions rate was as follows: 5 percent of the principal sum that was brought in * * * and 20 percent of what was called the "continuance" [i. e., the profits, or purported profits, in the customers' accounts].
Q. You got $100 a week from Gongoll himself and not from Financial Associates of Washington? Every time you sold a unit [i. e., obtained $1,000 from a client], you then got 5 percent, or $50, of that thousand; and any time a profit of $100 was credited to that customer, you got $20?
A. Yes.

One of Gongoll's salesmen received over $25,000 in 1937. Another employee testified as follows:[14]

Q. How much salary did he [Gongoll] pay you during that period [September 1937 to August 1938]?
A. $600 [a month.]
Q. What did you do to earn that salary?
A. Simply, I was an employee of Mr. Gongoll.
Q. What was your work?
A. It varied. I didn't do much of anything.

Gongoll was insolvent as early as October 1937, and probably earlier; yet, by paying higher monthly "profits," he obtained approximately $600,000 in new money during his last year of operation. He was thus able to meet old customers' demands for funds with the deposits of new customers. In a desperate effort to forestall the exposure of his insolvency, he not only made flagrantly false statements and paid unearned "profits" but also engaged in fraudulent practices of a much graver nature. His most serious offense was the sale of customers' collateral and the appropriation of the funds received therefrom. When customers opened commodity accounts with Gongoll they were required to deposit margin money in the form of either cash or securities. Gongoll had no authority to dispose of these funds except with the consent of his clients, but, in order to keep up his fraudulent "profit" payments, he sold his customers' securities. However, he continued to send customers checks which ostensibly represented dividends and interest paid on their stocks and bonds by the issuing corporations. In this manner he maintained the fiction that he still held these securities.

Obviously Gongoll could continue his fraudulent operations only so long as he succeeded in obtaining a steady and ever-increasing flow of new money to meet past obligations. The complaint served by the Commodity Exchange Administration put an end to this essential

[13] Statement of the manager of Financial Associates of Washington, Inc., a Gongoll-controlled company, before officials of the Commodity Exchange Administration, Minneapolis, October 7, 1938.
[14] Statement of an employee of S. W. Gongoll, before Hennepin County (Minn.) attorney, September 16, 1938.

condition. The Administration had obtained enough evidence to force an exposure of the situation, and customers, reading of the complaint in the press, began demanding their money. Thus, as was inevitable, Gongoll's fraudulent financial structure collapsed completely.

The report of the Federal receiver in bankruptcy stated that the total listed credit to Gongoll's clients was $3,193,940.27. Individual losses ranged as high as $30,000. The Federal receiver estimated that there were 4,000 customers with accounts on Gongoll's books at the time of his bankruptcy.

On October 8, 1938, a stipulation was signed by Gongoll's counsel and by the receiver of S. W. Gongoll & Co., bankrupt, giving the consent of Gongoll and the affiliated companies named in the Commodity Exchange Administration's complaint to a waiver of a hearing on that complaint. In this stipulation Gongoll admitted the violations of the Commodity Exchange Act alleged in said complaint and agreed that the Secretary of Agriculture might make findings and enter an order without the necessity of a hearing. The Secretary issued an order on November 3, finding Gongoll and the affiliated companies guilty of these violations. In consequence of this finding the Secretary ordered that all contract markets refuse, until further notice, all trading privileges to S. W. Gongoll and eight affiliated companies.

On December 16, 1938, Gongoll was found guilty of first-degree grand larceny in the Hennepin County (Minn.) State District Court, and was sentenced to a maximum of 10 years' imprisonment.

SELF-REGULATION BY THE EXCHANGES

More important than the prosecution of existing malpractices of commodity counselors is the formulation of regulations designed to prevent the recurrence of these abuses in the future. The Commodity Exchange Administration, under the Commodity Exchange Act, has only limited authority to regulate the operations of commodity counselors. Self-regulation by the various commodity exchanges is, therefore, the most practical approach to the problem at the present time, provided the exchanges not only adopt but also enforce adequate rules.

Prior to 1938 most of the exchanges had given little or no consideration to the question of regulating the practices of commodity counselors. The Chicago Board of Trade, however, adopted a regulation in 1933 which prohibited members from accepting a controlled account if the person operating the account through a power of attorney was to receive any remuneration for his services.[15] This regu-

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[15] Regulation 1820 of the Board of Trade of the City of Chicago. This regulation provided: "It shall be deemed unbusinesslike, detrimental to the welfare of the association, and inconsistent with just and equitable principles of trade for any member, registered partnership, or registered corporation (1) to accept any discretionary accounts for the purchase or sale of commodities unless the account is handled directly at the discretion of the member or of a partner of the partnership or an officer of the corporation; (2) to accept any discretionary accounts to be handled at the discretion of a member if the member shall share in the profits of such account unless the member shall also share in the losses in such account in equal proportion; (3) to accept an account where the person in whose name the account is held is acting for and on behalf of any other person and is receiving or is to receive any direct or indirect remuneration for so doing. Nothing herein contained shall be construed to prevent the recognition and fulfillment by a member, an officer of a registered corporation, or partner of a registered partnership of a bona fide power of attorney executed by a customer to a third person, granting to that person authority to exercise all or some of the rights of the customer over such account and stipulating therein (or by accompanying documents) that such third person is acting as such attorney without remuneration."

lation (No. 1820) was obviously designed to eliminate the operations of commodity counselors without placing restrictions on the nonprofessional class. In adopting regulation 1820 the Chicago Board of Trade acted on the logical theory that commodity counselors would not manage accounts for nothing. But the Board of Trade failed to foresee the development of various methods of evading its regulation, such as the joint-fund plan and control through dummies.

As a result of the Administration's investigation of controlled accounts, it was apparent that regulation 1820 could not be successfully enforced and that a new type of regulation should, therefore, be adopted. Furthermore, the Administration's investigation clearly indicated that regulatory action should be taken by all commodity exchanges since counselors were actual or potential traders on all of them. In order to discuss the methods of meeting this problem a conference between representatives of the various exchanges and officials of the Commodity Exchange Administration was held in Washington, August 1, 1938.

At this conference officials of the Administration outlined the findings of the Administration from its investigation and described briefly the various techniques used by commodity counselors in misleading their clients. There was general agreement that, by and large, the activities of counselors were detrimental to the public interest and to the futures markets. At the suggestion of officials of the Administration that specific rules be made to eliminate the abuses which had been described, several proposals were made at the conference and were subsequently adopted by most of the exchanges.

Between September 1938 and April 1939 regulations were adopted by 14 of the 17 contract markets in the United States, as follows:

Exchange	Regulation adopted
Board of Trade of the City of Chicago	Sept. 20, 1938
Chicago Open Board of Trade	Oct. 21, 1938
Milwaukee Grain and Stock Exchange	Oct. 24, 1938
New York Cotton Exchange	Nov. 3, 1938
Merchants Exchange of St. Louis	Nov. 9, 1938
Portland Grain Exchange	Nov. 15, 1938
Duluth Board of Trade	Dec. 22, 1938
Board of Trade of Kansas City, Missouri	Jan. 10, 1939
Wool Associates of the New York Cotton Exchange	Jan. 18, 1939
New York Mercantile Exchange	Feb. 8, 1939
Chamber of Commerce of Minneapolis	Feb. 10, 1939
New Orleans Cotton Exchange	Mar. 1, 1939
Chicago Mercantile Exchange	Mar. 29, 1939
New York Produce Exchange	Apr. 24, 1939

All these exchanges have incorporated the proposals made at the conference in their regulations. The following regulation, adopted by one exchange, is, in general, typical of all of them:

(1) No account for the purchase and sale of commodities for future delivery on this Exchange shall be accepted or carried where the party in whose name the account is held is known to be acting for and on behalf of others unless such party is registered with the Secretary of Agriculture as a futures commission merchant under the provisions of the Commodity Exchange Act.

(2) No account for the purchase and sale of commodities for future delivery on this Exchange shall be accepted or carried for any person who has given

trading authority to another person, not a member of the same family, unless the following requirements are observed:

(a) a monthly statement shall be sent directly to the customer showing the exact position of the account, including all open trades figured to the market;

(b) each transaction shall be specifically designated with the customer's name at the time the order is accepted;

(c) no transaction shall be held open in the customer's account which can be closed by making up an account purchase and sale;

(d) confirmations of all trades shall be sent promptly to both the customer and the party acting for him.

In addition to these provisions, two exchanges, the Chicago Board of Trade and the Chicago Open Board of Trade, require that a customer, who authorizes a third party to trade for him, sign a letter which is designed to apprise him of the risks involved in this type of trading. The regulations adopted by 4 of the 14 exchanges apply only to cases in which the manager of an account participates in its profits. This limitation is intended to take the place of the provisions of the other regulations which exempt accounts owned and operated by members of the same family.

The most significant provisions of the rules are those relating to the information which commission merchants must furnish the owners of controlled accounts. In all the regulations these provisions are virtually identical with paragraph (2) of the regulation quoted above. The general purpose of these requirements is to give the customer true and complete information concerning the transactions made by counselors in his behalf. Specifically, the regulations prohibit the practices, found to be widespread in recent years, of closing out only profitable trades to give the customer the impression he is making money when in fact there are large losses in open trades; of designating orders after their execution to the advantage of certain customers and the disadvantage of others; and of keeping the customer completely ignorant of the transactions being made for him.

These regulations do not prevent individuals from accepting the services of commodity counselors. If an individual does patronize a counselor, however, he will be fully and promptly informed, under these regulations, of the exact nature of the trading being done for him. If the regulations are effectively enforced they should eliminate the major malpractices by which counselors have misled or deceived their clients.

SUMMARY AND CONCLUSIONS

This report sets forth the findings of the Commodity Exchange Administration in its first investigation of controlled commodity futures accounts, that is, accounts over which persons other than the owners exercise trading control. The investigation was made in 1938 in response to numerous complaints concerning the operation of such accounts.

During the first 8 months of 1937 there were 4,488 controlled accounts, operated by 3,257 individuals, open on the books of 243 registered commission merchants. A large majority of the persons who held authorizations to trade were relatives, friends, or business associates of the owners of the accounts. In such cases the use of controlled accounts may have benefited the individuals concerned and,

in any event, it does not appear that the public interest was adversely affected.

There were approximately 600 accounts controlled by commodity counselors who solicited the management of commodity accounts among the general public and received remuneration for directing the trading in such accounts. It is primarily this type of controlled account that has given rise to complaint. In general it was found that commodity counselors obtained accounts on the basis of misleading statements and misrepresentations of fact; that many accounts were operated in a manner which misled the owners; that the mode of operation of some of them may have impeded the price-determining functions of the commodity markets; and that the overwhelming majority of these accounts was unprofitable. One counselor, who defrauded several thousand clients of approximately $3,000,000, was denied trading privileges on all contract commodity markets and was subsequently convicted of grand larceny.

This investigation clearly showed that many commodity counselors had adopted socially undesirable practices. A conference to consider means of correcting this situation was therefore called by the Commodity Exchange Administration in August 1938. All contract markets were invited to send representatives and most of them were represented. At this conference the Administration outlined the findings from its investigation and suggested that the various exchanges adopt regulations which would eliminate the malpractices of commodity counselors. All but three small contract markets have adopted such regulations.

This report is issued as evidence of the need for the action taken by the exchanges, and in the belief that full publicity concerning the activities of commodity counselors will contribute to a better public understanding of their methods and the results of their operations.

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U. S. GOVERNMENT PRINTING OFFICE: 1939

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